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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 361

BURTON-SUTTON OIL COMPANY, INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

SUPPLEMENTAL MEMORANDUM FOR THE RESPONDENT

The Commissioner's memorandum, in not opposing the granting of a writ of certiorari in this case, pointed out (p. 9) that the decision in *Kirby Petroleum Co.* v. *Commissioner*, No. 56, this Term, might be decisive of the issue presented here. We believe that the decision entered in the *Kirby* case on January 28, 1946, does not determine the controversy in this case, that the decision below may conflict in principle with the decision of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner* v. *Felix Oil Co.*, 144 F. 2d 276, and that the issue is an important one in the administration of the revenue which ought to be resolved

by this Court. Accordingly, we urge that the petition for certiorari be granted.

In the present case, the taxpayer acquired the working interest in an oil and gas lease, undertaking to pay 50 percent of its net profits from operations to its transferor's assignor, the Gulf Refining Company, hereafter referred to as Gulf. It also undertook to pay overriding and underlying oil royalties to the original lessor and lessee. The Tax Court and the court below held that the taxpayer could not deduct or exclude from its taxable income the net profit payments made to Gulf. Accord: *Quintana Petroleum Co.* v. *Commissioner*, 143 F. 2d 588 (C. C. A. 5th). The decisions below, of necessity, also determine that Gulf may not deduct the depletion allowance with respect to the net profit payment received by it from the taxpayer. In contrast stands the decision in the *Felix* case, where, although the lessor, as is true of Gulf in the present case, did not reserve any oil royalties, it was, nevertheless, held to be entitled to the depletion allowance with respect to certain net profit payments received from its lessee.

The present case may be distinguishable from the *Kirby* case in two separate respects, or those distinctions may be entirely immaterial, depending upon the precise grounds upon which the *Kirby* case was decided. In this case, Gulf's only interest in the oil in place was returnable from net profits; in the *Kirby* case the lessor was en-

entitled to a share of gross production by way of oil royalties and also to a portion of the net profits. The Tax Court has considered the reservation of an oil royalty to be an important element in deciding whether the right to a share of net profits evidences a depletable interest. Cf. *Estate of Japhet* v. *Commissioner*, 3 T. C. 86, 91–93; *Crawford* v. *Commissioner*, decided March 24, 1944 (1944 P–H T. C. Memorandum Decisions, par. 44,098). We are not wholly clear as to whether, under the *Kirby* opinion, the absence of an oil royalty in this case is material so that Gulf is to be denied the depletion allowance with respect to the net profits received (and the payments made are to be included in the taxpayer's income) on the ground that Gulf does not have a royalty interest in the lease. Insofar as the *Kirby* opinion states that (slip opinion, p. 6) "a share in 'net profits', dissociated from an economic interest, does not entitle the holder to a depletion allowance", it tends to support the decision below. Accord: *Helvering* v. *O'Donnell*, 303 U. S. 370; *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372. On the other hand, the *Kirby* opinion also states (fn. 6, slip opinion, p. 4) that a royalty interest "would not show an economic interest in oil not necessary for the payment of the royalties," that (slip opinion, p. 4) "The lessors' economic interest in the oil is no less [than that reserved by an oil royalty] when their right is to share a net profit," and that,

even if the only payments made by a lessee consisted of a portion of net profits, the payments would be deductible by the lessee as (slip opinion, p. 5) "rent or royalty paid * * * for the privilege of extraction." These statements would tend to support the theory that, despite the absence of a royalty interest, Gulf's interest is a depletable one and that, contrary to the decisions of the courts below, the payments made by the taxpayer are deductible.

The decision below might also be distinguishable on the ground that the working interest here was transferred by an assignment rather than a lease. The Tax Court, on occasion, has considered this an important factor. See *Innis* v. *Commissioner*, decided June 29, 1945 (1945 P-H T. C. Memorandum Decisions Service, par. 45,246); *Williams Bar Dredging Co.* v. *Commissioner*, decided June 30, 1945 (1945 P-H T. C. Memorandum Decisions Service, par. 45,244); *Gracey* v. *Commissioner*, 5 T. C. 296, 301–303.[1] The opinion in the *Kirby* case would seem to negate the fact that the technical difference between an assignment and a lease is of controlling significance since it follows the earlier decisions of this Court to the effect that (slip opinion, p. 3): "The technical title to the oil

[1] The *Williams Bar Dredging Co.* and *Gracey* cases are now pending on appeal in the Circuit Courts of Appeals for the Ninth and Fifth Circuits respectively; whether the Government should appeal from the *Innis* decision is now under consideration.

in place is not important. Title in a case of a lease may depend upon the law of the state in which the deposit lies." In this respect, the difference under state law between the legal relationship of an assignor or a lessor to the oil in place would not be of any significance and the decision below would not be distinguishable from the *Kirby* case because Gulf was an assignor rather than a lessor.[2] However, the *Kirby* opinion also distinguishes the leases there involved from cases where net profits from production have been retained, but a "sale" of the oil in place has been made (slip opinion, p. 6). In this view, should an assignment be considered as effectuating a sale of the assignor's interest, and if this case should turn on the fact that the transfer here was denominated an "assignment", the decision below would be correct. However, we wish to call the Court's attention to the fact that the assignment here (R. 59) imposed certain drilling obligations on the assignee and required him to continue

[2] It may be observed that, generally speaking, the only practical difference between the rights of an assignor and a lessor is the reversionary interest of the latter. Since the usual oil and gas lease runs for as long as oil and gas may be produced in paying quantities, the reversionary rights of a lessor to the oil in place are only of theoretical importance. As is true in this case, the affirmative duties of the assignee may not be materially different from those of a lessee. Cf. *West* v. *Commissioner*, 150 F. 2d 723 (C. C. A. 5th), certiorari denied, January 28, 1946, Nos. 667, 668, 669, and 670, this Term.

"such operations" on the land as would be required to continue the original lease in effect; if the assignee failed to fulfill his obligations, he was required to reassign the lease to the assignor. Thus, the relationship between the assignor and assignee was, in many respects, similar to that which exists between a lessor and lessee of an oil and gas lease. Accordingly, if the decision in the *Kirby* case rested upon the fact that the recipient of the net profit payments there was a lessor and that the lease did not amount to a sale of the oil in place, it is necessary to decide whether the relationship between the parties here is more closely related to that which existed in the *Kirby* case or that which obtained in *Helvering* v. *Elbe Oil Land Co., supra,* where a share of net profits was reserved, but the transaction took the form of a sale.

CONCLUSION

In view of the foregoing, it is respectfully urged that the petition for a writ of certiorari be granted.

Respectfully submitted.

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